

STATE BOARD OF ACCOUNTS
302 West Washington Street
Room E418
INDIANAPOLIS, INDIANA 46204-2765

AUDIT REPORT
OF

PUBLIC EMPLOYEES' RETIREMENT FUND
BOARD OF TRUSTEES
STATE OF INDIANA

July 1, 2004 to June 30, 2005



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AGENCY OFFICIALS

<u>Office</u>	<u>Official</u>	<u>Term</u>
Executive Director	Craig Hartzler Bruce Kimery (Interim) David Adams	07-01-04 to 01-10-05 01-11-05 to 03-07-05 03-08-05 to 06-30-06
Chairman of the Board	Jonathan Birge Ken Cochran	11-09-01 to 04-08-05 06-17-05 to 07-16-06



STATE OF INDIANA

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TO: THE OFFICIALS OF THE PUBLIC EMPLOYEES' RETIREMENT FUND

We have audited the financial statements of the Public Employees' Retirement Fund Board of Trustees as of and for the year ended June 30, 2005, and have issued our opinion thereon dated December 12, 2005. The financial transactions of this office are reflected in the Public Employees' Retirement Fund of Indiana's Comprehensive Annual Financial Report.

In planning and performing our audit, we considered the internal controls over financial reporting in order to determine our auditing procedures for the purpose of expressing our opinion on the financial statements and not to provide assurance on the internal control over financial reporting. However, we noted certain conditions in the design or operation of one or more of the internal control components that, in our judgment, could adversely affect the Board's ability to record, process, summarize, and report financial information or does not reduce to a relatively low risk that misstatements in amounts that would be material in relation to the financial statements being audited may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions.

We also noted certain issues of noncompliance with statutes, board policies, or contracts that in our opinion should be communicated to management.

The internal control conditions and the issues of noncompliance are disclosed in the following audit results and comments.

STATE BOARD OF ACCOUNTS

December 12, 2005

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INTERNAL CONTROL STRUCTURE AND ENVIRONMENT

An internal control structure is comprised of the control environment, risk assessment, control procedures, monitoring and the information and communication that are to occur throughout the processes. The control environment is the foundation for all other components of internal control.

In our prior seven audit reports (most recently B25060), we disclosed that certain components of the Public Employees' Retirement Fund of Indiana's (PERF) internal control structure had not been designed or implemented in order to ensure that control procedures, information and monitoring occurred. The components identified included reserve reconcilements and investment accounting and transfers. These areas were again found to have control weaknesses and findings that are detailed further in this report. Our prior report also found an inadequate overall internal control design and level of control consciousness both with respect to previously reported areas, as well as to the computer system that was implemented for retirement transactions in May 2002.

A material weakness in internal control is a condition in which the design or operation of one or more of the internal control components does not reduce to a relatively low level the risk that misstatements, or irregularities in amounts that would be material for a fund may occur and not be detected within a timely period by employees in the normal course of performing their assigned functions. During the fiscal year ended June 30, 2005, in our judgment, there were six conditions of material internal control weaknesses for the funds. These are further described in the following audit results and comments:

Reserve Reconcilements
Investment Accounting and Transfers
Lack of Benefit Transaction Accounting
Benefit and Refund System Control Weaknesses
Modifications to SIRIS Transactions
Legislators' Defined Contribution Fund Not Reconciled

Two of the above conditions had transactions with amounts material to the funds that were considered irregular as unsubstantiated or without evidence of proper authority. These also led to uncertainties as to the reliability of system output as well as completeness in regard to the reserves. These include: Reserve Reconcilements and Modifications to SIRIS Transactions. Other findings of noncompliance as to legal requirements are stated in:

Board Minutes

There were three findings with internal control weaknesses that represented a risk of undetected errors, misstatements, or irregularities that could have been significant to the funds affected:

Tax Withholding Remittance Errors
Internal Control Over Contribution Revenue Collections
1977 Police and Fire Fund Contributions

In our prior report there were nine specific findings of conditions of inaccurate retirement benefits or refunds processed that had either remained uncorrected from the prior year, or were also continuing conditions of error processing. These were caused by system processing errors, manual errors, lack of adequate staff training, and lack of adequate monitoring of the final calculations. Resolutions for seven of the nine conditions appear to be within the scope of a new process being implemented by PERF. These seven were combined into one current finding entitled Benefit and Refund Errors and are as follows:

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Overpayment of Benefits - Early Retirement Factor
Final Annuity Savings Account Contributions Not Paid
Final Quarter Interest Not Paid
Incorrect Monthly Benefits
Retroactive Perf Disability Benefit
Incorrect Refunds - Death In Service
Interest Credit to 1977 Fund Members

The other two conditions that continue from the prior report are reported as follows:

Underpayment of State Employee Disability Pensions
Unpaid Retroactive Benefit

Additionally all funds had conditions of inaccurate funding of benefits that are described in the finding:

Employer Reserve Charges

By June 2004, PERF had identified and begun projects to address prior findings. Two CPA firms were contracted to: compile and reconcile cash and reserves; review and design internal control procedures, including the associated computer access; and recalculate retiree benefits. These projects were ongoing during the current audit period.

IC 5-10.3-3-7.1 states: "The board shall annually analyze for internal control purposes the fund's; (1) income and expenditures; (2) actuarial condition; (3) reserve accounts; (4) investments; and (5) such other data as necessary to interpret the fund's condition and the board's administration of the fund."

RESERVE RECONCILEMENTS

In our prior seven audit reports (most recently B22849 and B25060), we have stated that the member and employer reserves had unidentified variances between the subsidiary computer system records and the general ledger balances. From July 2000 to March 2002, no reconciliations were performed. During this time, a critical system conversion occurred. Prior to that time, and thereafter until June 2004, incomplete reconciliations were performed with resulting unidentified variances. PERF hired a CPA firm to perform a reconciliation project. According to the CPA firm, the unidentified variances largely existed as of June 30, 2002. Adjusting entries were recorded in the general ledger, effective June 30, 2004, to recognize the unidentified variances. The unidentified variances recognized were significant or material to each of the funds.

During the current audit period data downloads were utilized to make accounting entries and to provide the balances of the reserves. Accounting procedures were not yet implemented to verify the accuracy, validity, or completeness of transactions recognized, nor were reports generated for most SIRIS transactions. This phase of the project, known as the wrap around, is still in development. The lack of accounting procedures along with the transaction errors we noted during testing led to qualitative uncertainties as to possible further unidentified material omissions or misstatements of the reserve balances. While adjustments can be made for the quantitative errors, it is also due to qualitative uncertainties that we were unable to render an opinion as to the balances of the reserves, or their funded status at June 30, 2005. Specifically, we have noted the following quantitative and qualitative errors and concerns.

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The documentation of the entire SIRIS system remains incomplete. The definition, source, and timing of recognition have not been identified for either the SIRIS accounting entries or the SIRIS member and employer account transaction types. Each type of SIRIS transaction processed has not been associated to the reports, screens or data bases. Other transactions, such as payments for prior service credit, were found to have not been recorded in SIRIS. The relationship of certain transactions to the reserve entries on accounts has not been explained and has been shown to have a "disassociation". This was particularly found in two areas: use of anticipated final contributions at retirement, whereby amounts are paid out or annuitized over the amount in the members' accounts; and system overrides, which are used to effect correct payments without posting adjustments to the members' accounts.

Additional uncertainties are present due to concerns about the completeness and integrity of data in the subsidiary records. For example, no reserve entries were made to fund the retirements for those receiving the non-SIRIS processed benefit checks. The estimated total effect of this omission is calculated to be material to each of the pension funds, except for PERF, for which it is considered significant. We are further concerned as to the completeness of data retrieved for the reserve accounting information, as no verification process is in place. The totals per the data extracts for the PERF and 1977 Fund members did not agree to the grand total of the member account balances per the earnings reports produced by the system on June 30, 2005. There was no SIRIS report available on June 30, 2005, to provide the total employer balances for any of the funds, or the member balances for the Judges' fund. As such, we cannot ascertain whether the data agrees to SIRIS output. Also, the integrity of the subsidiary record data is in question as transaction dates were modified, and other changes were made to prior year transaction totals that remain to be explained. (See also Modifications to SIRIS Transactions). There are also concerns as to the effect of the prior year adjusting entries for unidentified variances between the data and the general ledger. The causes of which remain unknown. An uncertainty also remains as to the employer receivable balances maintained within SIRIS. These receivable balances are material to the PERF and Judges funds. The largest of these transactions was recorded upon system conversion in 2002, and is not considered as owed to the funds.

Material errors have been recognized for benefit funding transactions. As noted in the finding entitled Employer Reserve Charges, we have identified a cumulative total of \$1.2 billion in excessive retirement costs that were recorded to PERF employer accounts on SIRIS from August 2000 through June 2005. These were comprised of individual retirement charges recorded in excess of \$350,000, which referenced deceased retirees for whom no retirement costs were necessary, or second retirements, for which charges would be significantly reduced. Of this, \$14 million was recognized on the general ledger as transfers from the employer reserves to benefits in force during the fiscal year ended June 30, 2005.

An identified material allocation error occurred in the data for employer accounts as well. In May 2005, entries were posted to the SIRIS employer accounts of all funds that recorded the unreserved fund balance as of June 30, 2004. This was a logic error, as the unreserved fund balance is a presentation of the funded/unfunded amount for the whole fund and does not represent a funding actually provided by employers. It should not be posted to employer's actual accounts as it would distort funding.

IC 5-10.2-2-2 directs that the Board of Trustees of the Public Employees' Retirement Fund shall establish separate accounts designated the retirement allowance account and the annuity savings account. IC 5-10.2-2-6 further requires separate accounts for employer contributions from the state and each political subdivision be maintained within the retirement allowance account.

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IC 5-10.3-3-7.1 provides that:

"The board shall annually analyze for internal control purposes the fund's;

- (1) income and expenditures;
- (2) actuarial condition;
- (3) reserve accounts;
- (4) investments; and
- (5) such other data as necessary to interpret the fund's condition and the board's administration of the fund."

MODIFICATIONS TO SIRIS TRANSACTIONS

Each transaction recorded to a member or an employer account on the SIRIS system has a transaction date and an effective date. The transaction dates were used to compile accounting totals from the SIRIS data. One of the effects of changing or incorrectly assigning transaction dates is to omit transaction amounts from current data collections that are used to provide accounting information.

In our test of member refunds we found transactions processed in 2005 that had the original transaction dates changed to the 1980s. Upon further inquiry PERF identified that in June 2005, a computer data change was implemented that inadvertently changed the transaction and effective dates for 1,424 member refunds and retirements processed. The dates were changed to the 1970s and 1980s. In September 2005, another data change was made in order to reestablish the dates to their original date. The original dates for the transactions were identified as occurring from April 2001 to June 2005. We were not provided with the detail as to how the transactions affected were identified, or how the original dates were ascertained. We cannot ascertain if all of the dates were reestablished correctly. On three other occasions in fiscal 2005, transaction dates were changed for select individuals in order to have balances correctly reflected on member account statements.

When the transaction dates have been modified or incorrectly assigned, then the process to identify the transactions for accounting information becomes complex. It requires cumulative data comparisons between current cumulative totals of transactions and a prior cumulative transaction data set. Such cumulative transaction analysis was performed at our request in conjunction with the reserve reconciliation project. It revealed that other member transactions were also recorded to prior periods, including contributions and member interest added to member accounts, additional amounts removed from accounts at retirement, and adjustments to disability and retirement transactions. The cumulative total comparisons performed identified that total amounts recorded for transactions were modified, but did not identify the exact transactions. The adjustments which reclassified retirement fund transfer transactions to that of disability transactions were made in amounts material to each fund. The accounting department did not have information as to the basis for the transactions and so did not record them in the general ledger as of June 30, 2005. These transactions, when identified, would be recognized in the fiscal year ended June 30, 2006.

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Conditions of having unintended results upon processing an unrelated computer change order, as we described above, indicate a weakness in the testing of such computer program changes. While staff tested the intended results, there were no reports run to ensure there was no unintended result or effect to accounting information. Reports have not been designed that would identify transactions that change the prior balance. Policies have not been developed to consistently communicate data change requests to the accounting department.

Certain SIRIS processes have been programmed to set the transaction date as equal to the effective date which is in a prior period. There were no reports produced to identify such transactions as a change to the prior balance. A SIRIS function was modified to assign transaction dates for certain contributions posted as the effective date. Earnings posted to member and employer accounts also had the transaction date set to the effective date.

IC 5-10.3-3-7.1 states: "The board shall annually analyze for internal control purposes the fund's; (1) income and expenditures; (2) actuarial condition; (3) reserve accounts; (4) investments; and (5) such other data as necessary to interpret the fund's condition and the board's administration of the fund."

As part of common business practices, which are provided in our accounting manuals, governmental units should have internal controls in effect which provide reasonable assurance regarding the reliability of financial information and records, effectiveness and efficiency of operations, proper execution of management's objectives, and compliance with laws and regulations. Among other things, safeguarding controls over cash and all other assets and all forms of information processing are necessary for proper internal control.

The following are common business practices applicable to computer systems processing accounting information as provided in our accounting manuals:

The computerized accounting system must maintain electronic audit trails sufficient to trace all transactions from original source of entry into the system, through all system processing, and to the results produced by the system. The audit trails must also maintain sufficient information to trace all transactions from the final results of the system, through all system processing, and to the original source of entry into the system. These audit trails must be protected from modification and deletion.

Accounting information must not be modified by computer utility programs which are not contained in the accounting application system.

Computer programmers must not have access to production accounting information.

All modifications to computer source codes must be adequately tested.

The accounting application system must be supported by computerized and manual procedures to assure the following controls related to error correction: the type of error condition is recorded; the original transaction creating the error is retained within the system; a reversing transaction to eliminate the effect of the error on the appropriate value is entered and retained within the system; the correct transaction is entered into the system and recorded; and the management approval for this error correction is documented.

The computerized accounting system must incorporate features that assure all accounting information is reported accurately and completely.

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EMPLOYER RESERVE CHARGES

As stated in our prior two Audit Reports B22849 and B25060, employer reserve charges are the actuarial costs to the employer for the funding of the member's pension at retirement. In our testing of employer reserve charge amounts we found that incorrect actuary tables were used to calculate the pension funding for all other funds except PERF. We also found that the table factors were incorrectly applied, for all funds except PERF and the 1977 Fund. Employer reserve charges were incorrect for the 1977 Fund death in service benefits tested.

On November 19, 2004, the PERF Board of Trustees formally adopted actuarial reserve factors for all of the defined benefit plans administered. These were adopted to reflect the current mortality and interest rates used in the preparation of annual actuarial evaluations. As of June 30, 2005, these tables had not been implemented in the system for use in determining employers' charge amounts for retirements.

Finally, as stated in our prior audit report, excessive reserve charges were recorded onto PERF employer accounts in SIRIS. We found these excessive charges to be a cumulative total of \$1.2 billion at June 30, 2005. This total accumulated from August 2000 through June 2005, with \$14 million recorded during fiscal 2005. \$881 million had been identified by PERF in fiscal 2004 but not backed out of SIRIS. These charges were largely referenced to deceased retirees, for whom no additional actuarial costs are owed. The cause for these charges could not be determined, but appear to be generated by SIRIS. Smaller system variances could occur on an ongoing basis and remain undetected.

The actuary tables that were adopted by the Board of Trustees in accordance with IC 5-10.3-3-7(7) should be accurately applied.

INVESTMENT ACCOUNTING AND TRANSFERS

Our prior six prior audit reports (most recently B22849 and B25060) stated that PERF did not have procedures in place to ensure that: contributions are deposited in the appropriate investment accounts and are recorded in the correct fund's unitized owner account; transfers are between authorized accounts; transactions are in compliance with Board decisions and directives; and a timely review of custodian bank reports has occurred. Evidence of such controls and results should also be established and communicated to management on a regular basis, and made available for audit.

Certain controls have been implemented whereby PERF did detect errors and performed corrections of those errors. However, concerns remain as to the timely detection of errors or irregularities. PERF is provided with online access to its bank account information. Through inquiry we did not find a policy that addressed the timing and documentation of the verification process that ensures all transfers out of the portfolio were properly authorized, agreed to checking account deposits, and with results communicated to management on a regular basis.

Errors identified in our prior reports were corrected by June 30, 2005, except for a \$3 million investment transferred into the Consolidated Retirement Investment Fund (CRIF) account in February 2003. This needs to be recorded as owned by the PERF Fund.

Without timely corrections of errors or omissions, a change in investment income recognition between owner funds is necessary.

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IC 5-10.3-3-7.1 states: "The board shall annually analyze for internal control purposes the fund's; (1) income and expenditures; (2) actuarial condition; (3) reserve accounts; (4) investments; and (5) such other data as necessary to interpret the fund's condition and the board's administration of the fund."

LEGISLATORS' DEFINED CONTRIBUTION FUND NOT RECONCILED

Our prior Audit Report B25060 stated that beginning January 1, 2004, the PERF Board implemented a pilot program for the Legislators' Defined Contribution Fund by contracting with a service provider to implement daily investment selections. The contractor maintains detail accounts for each member and performs the necessary bank transactions associated with member options. The PERF Board had not obtained or required a reconciliation of the service provider's records to the associated bank records as of June 30, 2004. A reconciliation was also not prepared for the fiscal year ended June 30, 2005.

At June 30, 2005, the Legislators' Defined Contribution Fund did not have funds available to reimburse two other pension funds a total of \$477,208. The only funds that were not designated to participant accounts totaled \$73,780 leaving a shortfall of \$403,428 at June 30, 2005. It appears that the condition existed as of June 30, 2004, and perhaps was a condition in prior fiscal years.

During the fiscal year ended June 30, 2005, funds which we reported last year as held in excess of the members accounts, were used to increase member account balances in order to recognize transactions that had not been converted. The data originally converted to the contractor did not include the contributions received for the period July 1, 2003, to December 31, 2003, or the investment earnings recorded for the quarter ended December 31, 2003. The contributions were recorded on member accounts on July 21, 2004. On March 31, 2005, the contractor recorded \$89,490 to some member accounts for earnings as of December 31, 2003. It remains unclear as to how other earnings for the quarter ended December 31, 2003, were converted. To date, there has been no reconciliation performed of the conversion of the SIRIS data to the contractor.

On November 1, 2004, \$111,120 was recorded to three participant accounts in order to correct their balances, which were in error at conversion. As there were no funds available to invest these member balances owed, funds were provided by the Legislator Defined Benefit fund and are part of the totaled owed mentioned above. The largest of these transactions was owed because the PERF computer system SIRIS had removed the member's entire account balance in March 2003, even though no payments were requested or issued. The other two members were owed funds as their confirmed investment direction orders were not implemented in 2003.

We are uncertain as to whether any amounts remain owed to members, or whether members' accounts were overstated by errors in calculating earnings applied to their accounts prior to, or upon conversion. We have been unable to ascertain the accuracy of balances held for members of the fund for several years as the conditions reported in our finding Reserve Reconcilements also apply to this fund. Adjustments to compensate members for funds that were not invested in accordance with their directives would be a contributing cause of a fund shortfall. We are uncertain as to the cumulative total of such adjustments.

IC 2-3.5-5-2 (d) states that:

"Each participant shall be credited individually with:

- (1) the participant's contributions to the fund under section 4 of this chapter, which shall be credited to the participant's account;

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- (2) the contributions made to the fund on behalf of the participant under section 5 of this chapter, which shall be credited to the participant's account;
- (3) the amount transferred to the fund under subsections (b) and (c), which shall be credited to the participant's account; and
- (4) the net earnings on the participant's accounts, determined under section 3 of this chapter."

Public Law 126 - 2003 section 1 (d) (1) states that: "Notwithstanding IC 2-3.5-5-3(b) (2), the PERF board shall implement a member's selection under IC 2-3.5-5-3 not later than the next business day following receipt of the member's selection by the PERF board. This date is the effective date of the member's selection." Section 1(d)(2) states that: "Notwithstanding IC 2-3.5-5-3(b)(7), all contributions to a members' account in the fund must be allocated under IC 2-3.5-5-3 not later than the last day of the quarter in which the contributions are received and reconciled in accordance with the member's most recent effective direction."

Each agency is responsible for maintaining an effective and accurate accounting system for subsidiary and supplementary records. At all times, the agency's manual and computerized records, subsidiary ledgers, control ledger, and reconciled bank or auditor's balance should agree.

TAX WITHHOLDING REMITTANCE ERRORS

Our two prior Audit Reports B22849 and B25060, stated that errors were made in remitting the taxes withheld from benefit and refund checks. These errors resulted primarily in refunds due to the funds. During our current audit period, we reviewed the tax refunds claimed for the PERF fund for the calendar year 2004, and found that the claims filed were inaccurate. The refunds were claimed using tax liability totals from a SIRIS report of 1099 tax forms issued that appears to have been incomplete.

We compared the 2004 federal return for the PERF fund to the general ledger withholding account entries. We found that the general ledger account for the federal withholdings lists \$596,028 more in liabilities for the year than that claimed by PERF on the IRS form 945. The basis for the 2004 liabilities reported to the federal and state taxing authorities was a SIRIS report of the 1099 forms issued for the fund that was printed on January 8, 2005. However, we noted that the 1099 function of SIRIS had several types of errors and omissions identified by staff. Various revisions were noted as occurring through April 2005. The same condition is also likely to have occurred for the other funds administered by PERF, as their returns were filed using the same system reports and dates.

We also could not agree the June 30, 2005, balance of the PERF withholding accounts to the identified current withholdings owed by PERF. PERF does not maintain a subsidiary ledger that is reconciled to the general ledger.

Every governmental unit is required to comply with all filing requirements of federal and state agencies.

Officials and employees have the duty to pay claims, remit taxes, etc., in a timely fashion. Any penalties, interest or other charges paid by the governmental unit may be the obligation of the responsible official or employee.

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INTERNAL CONTROL OVER CONTRIBUTION REVENUE COLLECTIONS

As stated in our prior two Audit Reports B22849 and B25060, our testing of contribution revenue collections revealed deficiencies in the internal control structure. These include the following:

- (1) Duties were not sufficiently segregated in the processing of manual contribution payments. The same employee prepared the deposit, posted SIRIS, and posted the cash receipts ledger.

During our current audit period, PERF began to record contribution manual payments on a daily log sheet by other staff members in order to verify the work of the employee preparing the deposit and posting the payments into the system. However, there was no reconciliation between the daily log sheets and the deposits performed. Therefore, duties remained insufficiently segregated in the processing of manual contribution payments.

- (2) Temporary member accounts are set up for contributions received without accompanying member records. These accounts are changed to permanent when proper member record information is received. There is no monitoring performed to determine the status of temporary member accounts on the system to detect errors or misuse of those accounts. Beginning in September 2003, inactive temporary member accounts were frozen in SIRIS. An account that is frozen on the system cannot have transactions recorded until the account is unfrozen by authorized staff. Freezing of inactive temporary member accounts is performed quarterly.

The total value of the nonfrozen temporary accounts exceeded \$11 million at July 2005 per a SIRIS report. Many of these employees have balances in excess of \$15,000. PERF should contact employers to obtain the required documentation. Efforts to obtain this documentation should be monitored.

As part of common business practices, which are provided in our accounting manuals, governmental units should have internal controls in effect, which provide reasonable assurance regarding the reliability of financial information and records, effectiveness and efficiency of operations, proper execution of management's objectives, and compliance with laws and regulations. Among other things, segregation of duties, safeguarding controls over cash and all other assets and all forms of information processing are part of an internal control system.

IC 5-10.3-3-7.1 states: "The board shall annually analyze for internal control purposes the fund's; (1) income and expenditures; (2) actuarial condition; (3) reserve accounts; (4) investments; and (5) such other data as necessary to interpret the fund's condition and the board's administration of the fund."

1977 POLICE AND FIRE FUND CONTRIBUTIONS

As stated in our prior two Audit Reports B22849 and B22060, the 1977 Police Officers' and Firefighters' Pension and Disability Fund (1977 Fund) receives employer and employee contributions at the rate of 21% and 6%, respectively, of the salary of a first class officer or firefighter. PERF did not have adequate controls in place to ensure that employer and employee contributions were properly classified and recorded in the correct proportion to each other, or to identify reasons for differences. In fiscal 2005, a significant error

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was made in classifying contributions which indicated that planned procedures to ensure correct classification upon deposit were not yet implemented. The total contributions for February 3, 2005, of \$1,324,535, were classified as all employee contributions on the report of collection instead of being split between employer and employee contributions. This was subsequently corrected on the general ledger. We additionally found an error in classifying contributions received from one employer within a batch. The error was discovered by staff with the correct classifications posted to the computer system. However, there was no record that the error was communicated to appropriate staff or corrected on the general ledger.

In their response to the 2003 report, PERF stated that purchases of prior service credit are not separately classified from regular contributions. The CPA firm review in fiscal 2004 indicated that the prior service credit payments are not recorded in SIRIS. It is unclear as to whether these payments should be entered into SIRIS, or whether they are refundable, particularly if purchased on behalf of an employee by an employer.

IC 5-10.3-3-7.1 states: "The board shall annually analyze for internal control purposes the fund's; (1) income and expenditures; (2) actuarial condition; (3) reserve accounts; (4) investments; and (5) such other data as necessary to interpret the fund's condition and the board's administration of the fund."

As part of common business practices, which are provided in our accounting manuals, governmental units should have internal controls in effect, which provide reasonable assurance regarding the reliability of financial information and records, effectiveness and efficiency of operations, proper execution of management's objectives, and compliance with laws and regulations. Among other things, safeguarding controls over cash and all other assets and all forms of information processing are part of an internal control system.

BENEFIT AND REFUND SYSTEM CONTROL WEAKNESSES

As stated in our prior two Audit Reports B22849 and B25060, the processing of benefits and refunds occurs thru the computer system, which maintains the subsidiary accounts for the members and employers reserves. Control weaknesses over the processing of benefits and refund transactions in SIRIS included the following design weakness conditions:

PERF had certain system controls disabled such that disbursements against a member's annuity account may exceed the balance in the account. Additional monitoring was not implemented.

The segregation of duties that PERF may accomplish is limited by incompatible functions that exist within system defined roles that allows users to approve their own work. There also is no inquiry only capability, such that access to process transactions are given to those whose duties are to only observe transactions.

The system design was insufficient in order to ensure that benefits and refunds were calculated and paid accurately in an efficient, timely manner with respect to the processing of the final contributions.

SIRIS design omits a transaction to record final service credit. Service credit is regularly recorded in quarter year increments upon posting quarterly contributions. Upon retirement, the exact service credit must be calculated and compared to the system total. In order to post the exact service credit total, PERF staff must now access and delete contribution entries and re-enter the same

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contributions with the correct service credit. This design has required an additional level of review for this specific transaction to ensure the contributions are re-entered correctly. However, we observed that contributions were re-entered with a different effective date.

During fiscal 2004, we additionally found that the majority of SIRIS entries to deduct members' balances at retirement did not agree to the checks issued, if withdrawn, or to the amount annuitized. The association of the entry to the source transaction is required for an accurate accounting.

SIRIS operation weaknesses that pertain to the processing of benefits and refunds included the following:

- (1) Inadequate segregation of duties. Staff were generally assigned too much access. Combined role assignments give many users the ability to audit their own work or to perform incompatible functions within SIRIS.
- (2) SIRIS maintains check records for disbursement transactions that have been entered, but not yet authorized. No information concerning such check records is provided to the accounting department. As such, there were no procedures in place to research and resolve these transactions. Those which we found in 2003, which totaled over \$7 million, were deleted as their issuance would have resulted in a duplicate payment. The fiscal 2005 checks entered but unauthorized totaled \$291,016 for the PERF and 1977 fund.
- (3) Lack of monitoring of completed transactions to ensure both system and manual procedures were accurate and correctly applied.

In response to our prior Audit Report B22849, PERF hired a CPA firm to review internal controls including the roles within SIRIS as well as manual processes, and develop specific recommendations. The firm was also hired to monitor completed transactions and this remains an ongoing project.

IC 5-10.3-3-7.1 states: "The board shall annually analyze for internal control purposes the fund's; (1) income and expenditures; (2) actuarial condition; (3) reserve accounts; (4) investments; and (5) such other data as necessary to interpret the fund's condition and the board's administration of the fund."

As part of common business practices, which are provided in our accounting manuals, governmental units' computerized accounting system must provide input edits and controls to assure that information entered into the system is accurate, that all appropriate information is entered into the system, that information is entered into the system only once, and that all information entered into the system is authorized by management.

Written procedures must be available for all computerized accounting systems which provide instructions on the requirements for the approval of information prior to entry into the computer, as well as the accurate entry, processing, and reporting of information from the accounting system.

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LACK OF BENEFIT TRANSACTION ACCOUNTING

In our prior two Audit Reports B22849 and B25060, we stated that there was no definitive population data for new benefits, benefit adjustments, or benefit deletion transactions. The expected benefit payroll is not tracked or monitored by either number of expected checks to be issued or dollar amount authorized. These were designed to be provided in a Monthly Payroll Summary Report with further itemized detail provided in monthly reports entitled: New Retiree Detail, Monthly Benefit Adjustment Detail, Reinstated Retiree Detail, and Retirees Suspended/Terminated Detail. The reports are not functioning as designed. The transaction detail provided did not support the change in the monthly benefit payroll issued. Also, we found new retirements that were not reported.

Transaction information should be provided to managers for monitoring purposes. For the PERF Fund, pension administrators identify new retirements from a spreadsheet prepared internally to track files processed. There is no such listing prepared for the other funds administered by PERF.

PERF did not have procedures in place to ensure the benefits paid are valid and authorized.

For fiscal 2005, PERF accounting staff implemented a manual process of comparing the current and prior monthly check registers to identify the new, terminated, and adjusted retirees. This process is effectual in identifying the changes made to the check runs each month, after the payments are issued. However, control procedures are still not in place to monitor the expected benefit payroll, or to determine if the benefit transactions were valid. Determination of the validity of payees needs to be done by PERF management or staff that does not initiate or process the retirement transactions.

PERF is in the process of developing reports on the system that will track all new, terminated, and adjusted retirees to replace the manual process currently being done.

IC 5-10.3-3-7.1 states: "The board shall annually analyze for internal control purposes the fund's; (1) income and expenditures; (2) actuarial condition; (3) reserve accounts; (4) investments; and (5) such other data as necessary to interpret the fund's condition and the board's administration of the fund."

As part of common business practices, which are provided in our accounting manuals, governmental units' computerized accounting system must maintain electronic audit trails sufficient to trace all transactions from original source of entry into the system, through all system processing, and to the results produced by the system. The audit trails must also maintain sufficient information to trace all transactions from the final results produced by the system, through all system processing, and to the original source of entry into the system. These audit trails must be protected from modification and deletion.

The computerized accounting system must incorporate features that assure all accounting information is reported accurately and completely. Output reports must have appropriate subtotals to allow reconciliation of reports within the system and reconciliation to external documentation.

BENEFIT AND REFUND ERRORS

As stated in our prior two Audit Reports B22849 and B25060 under the audit results and comments entitled: Final Annuity Savings Account Contributions Not Paid, Final Quarter Interest Not Paid, Incorrect Monthly Benefits, Retroactive PERF Disability Benefits, Incorrect Refunds - Death in Service, and as stated in

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our prior Audit Report B25060 under the audit results and comments entitled Overpayment of Benefits -Early Retirement Factor and Interest Credit to 1977 Fund Members, we found various anomalies in calculation of members' benefit and refunds. As detailed in the prior reports these anomalies resulted in both under and over payments to members. These anomalies included the following:

- (1) Payment of full retirement benefits to some members who had retired under the provisions of a reduced early retirement;
- (2) Disability pensions calculated without including COLA increases that occurred between the effective disability date to the date that the pension benefit amount was determined;
- (3) SIRIS entries to remove member account balances as paid or annuitized not agreeing to the checks issued or annuity calculation;
- (4) Member balances remaining in SIRIS members' accounts subsequent to retirement or refund;
- (5) Certain retirements processed without the final quarterly interest posting;
- (6) Manual data entry errors;
- (7) Incorrect data used to calculate benefits, such as incorrect service credit or incorrect highest five year average wages;
- (8) Incorrect death in service refunds; and
- (9) Overpayment of interim interest.

The causes varied, but were mainly due to SIRIS programming anomalies, input errors, and incorrect data used for inputting. These errors were allowed to remain and in some instances to grow due to inadequate monitoring. These conditions continued during the current audit period.

As stated in our prior Audit Report B25060, PERF hired a CPA firm to recalculate all benefits and refunds that were processed from the inception of the SIRIS system in April 2002 through June 30, 2004. As of November 3, 2005, the CPA firm had completed these recalculations but considers the results preliminary until they pass the firm's quality control process. PERF has indicated that once this process is complete and a final report issued, PERF will implement appropriate corrections to their records as well as take appropriate action for under and over payments to members.

The CPA firm was also to develop a new process for implementation by PERF to help ensure the accuracy of all refund and benefit payments. PERF management indicated significant implementation of the new process began in fiscal 2006. This includes recalculating all benefits and refunds processed since July 1, 2004. As of November 3, 2005, recalculation had been completed for those benefits and refunds processed in July and August of 2004.

IC 5-10.3-3-7 states, in part: "the Board of Trustees shall . . . 5) Provide for the installation in the general office of a complete system of books, accounts including reserve accounts, and records in order to give effect to all the requirements of this article and to assure the proper operation of the fund."

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IC 5-10.2-2-1.5 states, in part: "(1) Each board shall distribute the corpus and income of the fund to members and their beneficiaries in accordance with the retirement fund law. (2) No part of the corpus or income of a fund may be used for or diverted to any purpose other than the exclusive benefit of the members and their beneficiaries."

As a part of common business practices, which are provided in our accounting manuals, governmental units should have internal controls in effect, which provide reasonable assurance regarding the reliability of financial information and records, effectiveness and efficiency of operations, proper execution of management's objectives, and compliance with laws and regulations. Among other things, safeguarding controls over cash and all other assets and all forms of information processing are part of an internal control system.

UNDERPAYMENT OF STATE EMPLOYEE DISABILITY BENEFITS

As stated in our prior two Audit Reports B22849 and B25060, state employees who become disabled may begin to receive their PERF disability retirement while also receiving the state long term disability benefit. Additional state service is earned while on the long term disability plan. The state disability plan administrator reports to PERF when the state disability benefit term is completed, which cannot exceed a four year term. The PERF pension benefit should then be increased by recognizing the total state service credit.

We stated in our prior audit reports that since May 2002 PERF had not recomputed any state employee disability retiree pensions after the completion of their coverage under the long term disability plan, unless the member contacted PERF to complain. We found during the current audit, through inquiry, that some of these recomputations would have been completed during the recalculation process detailed in the finding Benefit and Refund Errors. However, the scope of the recalculation process was not meant to target this issue and so any recomputation for additional years of service for the situation described in this finding would be incidental to the recalculation process. PERF has a process in place which, as described above, entails the state disability plan administrator reporting to PERF when the state disability benefit term is completed. A listing of this reporting is maintained at PERF. However, the listing does not indicate when a recomputation has been completed so we were unable to ascertain from this listing how many members' benefits have not been recomputed. Through inquiry we found that a backlog does remain and that recomputations occur mostly as a result of a member's complaint.

IC 5-10.2-3-1(f) states: "A member who is a state employee is entitled to service credit for the time the member is receiving disability benefits under a disability plan established under IC 5-10-8-7."

IC 5-10.2-2-1.5 states, in part: "(1) Each board shall distribute the corpus and income of the fund to members and their beneficiaries in accordance with the retirement fund law. (2) No part of the corpus or income of a fund may be used for or diverted to any purpose other than the exclusive benefit of the members and their beneficiaries."

UNPAID RETROACTIVE BENEFIT

As stated in our prior Audit Reports B22849 and B25060, new retirees receive a retroactive payment for all benefits owed from the effective retirement date to the payment date. This retroactive payment is to include all prior monthly benefits, plus additional unpaid thirteenth check pension benefit amounts since the

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effective retirement date. The thirteenth check represents additional benefits paid, as authorized by the legislature, which do not increase the base pension. Retroactive payment of the thirteenth check occurs primarily for disabilitant retirees.

When the thirteenth check pension benefit amount is included as part of a retroactive payment calculation, we found that there is computer coding that makes an adjustment to deduct the thirteenth benefit amount from the retroactive payment. Therefore, the thirteenth check pension benefit increase is not paid to those receiving the retroactive adjustment.

IC 5-10.2-2-1.5 states, in part:

- "(1) Each board shall distribute the corpus and income of the fund to members and their beneficiaries in accordance with the retirement fund law.
- (2) No part of the corpus or income of a fund may be used for or diverted to any purpose other than the exclusive benefit of the members and their beneficiaries."

BOARD MINUTES

Minutes of the Board of Trustees meetings held from September 2004 until March 2005 indicated that executive sessions were held, but did not identify the subject matters of the sessions, or provide the statutory reference for the allowable instances for holding an executive session, or include a certification statement that no other subject matter was discussed. We could not ascertain whether final actions were taken at a meeting open to the public.

IC 5-14-1.5-6.1(b) specifies the only instances in which an executive session may be held. "Public notice of executive sessions must state the subject matter by specific reference to the enumerated instance or instances for which executive sessions may be held under subsection (b). The requirements stated in section 4 of this chapter for memoranda and minutes being made available to the public is modified as to executive sessions in that the memoranda and minutes must identify the subject matter considered by specific reference to the enumerated instance or instances for which public notice was given. The governing body shall certify by a statement in the memoranda and minutes of the governing body that no subject matter was discussed in the executive session other than the subject matter specified in the public notice." IC 5-14-1.5-6.1(d). "A final action must be taken at a meeting open to the public." IC 5-14-1.5-6.1(c).

PUBLIC EMPLOYEES' RETIREMENT FUND
BOARD OF TRUSTEES
EXIT CONFERENCE

The contents of this report were discussed on December 19, 2005, with David Adams, Executive Director; and were mailed to Bruce Kimery, former interim Executive Director, and Craig Hartzler, former Executive Director, on December 20, 2005. The official response has been made a part of this report and may be found on pages 20 through 24.



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State Board of Accounts
Indiana State Board of Accounts
302 West Washington Street
Room E418
Indianapolis, Indiana 46204

Ladies and Gentlemen:

This letter serves as our response to the State Board of Accounts Audit Results and Comments for the Public Employees Retirement Fund (PERF) dated June 30, 2005. The results of this audit were presented to PERF on December 19, 2005. The PERF management team appreciates the comments and insights into some of the challenges that are impacting PERF.

The previous audit results for FY04 were presented on April 20, 2005. At that time, I had been the Executive Director of PERF for less than six weeks. PERF leadership worked very diligently to assess the organizational changes, technological changes and identify and establish the appropriate internal control processes and procedures. We are very encouraged by the progress made in resolving the previous audit findings in the two months prior to June 30, 2005. We are equally encouraged with the improvement of the audit process resulting in a dramatic reduction in the timeframe to complete the audit.

As noted, there are fifteen (15) audit findings for the fiscal year that ended on June 30, 2005. This represents a significant improvement over FY04. Through the commitment, planning and execution of the PERF leadership team and employees, audit findings were reduced from thirty (30) to fifteen (15), a 50% reduction.

Additionally, the final exit conference was conducted over 4 months ahead of last year's schedule. PERF leadership implemented an aggressive plan to improve the audit process.

The PERF leadership team continues to assess our business functions and to determine specific plans for operational and service improvements. PERF leadership will continue to make recommendations and take actions to improve our operations.



As stated in my previous letter to the State Board of Accounts, the complexity of the operational environment creates many challenges for PERF. We are taking the necessary steps to implement a plan for solving these longstanding problems. Implementation of this plan will continue to require significant time and resources. The PERF leadership team is already realizing the results of these efforts as reported by a significant reduction in audit findings. However, there is still significant work to be performed. The PERF leadership team is committed to the resolution of these issues.

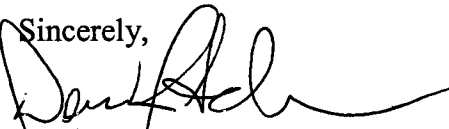
As part of PERF's process, we recognize that we must continue to improve customer service while resolving these issues. Since our last report we have implemented a Scorecard establishing the goals for the organization and measuring our progress on a monthly basis. PERF also reports this information to the Governor on a quarterly basis. Organizational goals include statewide dollar efficiency gains, financial performance of the fund, customer service goals, system measures and fundamental agency changes which include resolving the State Board of Accounts audit findings.

From a customer service perspective, highlights include the development of a 'Bridge to Retirement' program and the recent launch of the 'PERF Interactive' website. PERF is moving from an organization that processes checks to one that assists our future retirees with planning their retirement. The Bridge to Retirement outlines the necessary steps to assist future retirees with planning for retirement.

PERF Interactive provides customers the ability to interact with PERF on-line by providing services to update personal information, view account balances and change investment options themselves. We plan to provide additional capabilities in the future. Our customers now have the ability to interact with PERF anytime.

These are just some of the changes that are occurring at PERF to improve the service to our customers.

Again, I want to thank the State Board of Accounts for their insight and assistance. PERF looks forward to working with the State Board of Accounts to resolve findings and improve operations.

Sincerely,

David J Adams
Executive Director



OFFICIAL RESPONSE

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Mr. Bruce Hartman
State Examiner
State Board of Accounts
Indiana State Board of Accounts
302 West Washington Street
Room E418
Indianapolis, Indiana 46204

WWW.PERF.IN.GOV

Dear Mr. Hartman:

This letter serves as my official response to the State Board of Accounts Audit Results and Comments for the Public Employees Retirement Fund (PERF) for the time period July 1, 2004 to June 30, 2005 (FY 2005). I received a copy of the results of this audit on December 21, 2005

I was Acting Executive Director of PERF from January 11, 2005 until March 7, 2005, taking over from Mr. Craig Hartzler who left PERF as of January 10, 2005. Prior to assuming this role, I was Deputy Director of PERF. My primary responsibilities as Acting Executive Director were to ensure effective operations of the organization until the new Executive Director was hired on March 8, 2005.

I have reviewed the SBOA Report. As a PERF Member and Employee, I am pleased to see the progress the organization has made since it received the FY 2004 SBOA audit report in April of 2005. In the last audit year, PERF has significantly reduced the number of SBOA findings.

While PERF continues to have challenges brought about by the inherent complexity of our operations, I am confident that PERF's continued emphasis on customer service and process improvement will only help to resolve even more of the longstanding issues the SBOA has identified in its Report.

I appreciate the opportunity to respond to the SBOA Report.

Sincerely,

A handwritten signature in black ink, appearing to read 'Bruce Kimery', written over a horizontal line.

Bruce Kimery

cc: Mike Hoose, SBOA

OFFICIAL RESPONSE

January 5, 2006

Debbie Gibson, CPA
Auditor-In Charge
Indiana State Board of Accounts
302 W. Washington St.
Room E418
Indianapolis, IN 46204-2765

Dear Ms. Gibson:

Thank you for sending me the draft audit results and comments for the Indiana Public Employees' Retirement Fund (PERF) for the period July 1, 2004 to June 30, 2005. The opportunity to provide an official response to the audit is greatly appreciated. You and your staff are to be commended for their dedication and commitment to public service.

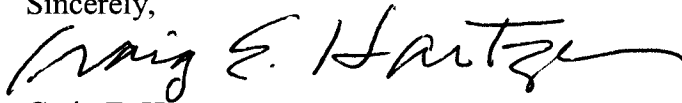
As the former Executive Director of PERF through January 10, 2005 and a current twenty year member of PERF, I am simultaneously disappointed and heartened by the results of your audit. It is very disappointing to learn from this report that many problems identified in earlier audits still exist. We all understood, however, that the problems did not occur overnight and would not be fixed overnight. I am heartened by the fact that during my tenure as the Executive Director and with the leadership of the Board of Trustees at that time, significant systematic actions were taken to develop solutions and execute fixes to many of the problems identified by members of PERF, the PERF staff, and the State Board of Accounts. It also encouraging to know that this effort to fix problems and make positive changes at PERF has continued under the new leadership.

Let me offer some specific comments in response to several of the problems identified in the audit. First, I am encouraged to learn from the audit that the two outside expert CPA firms hired during my tenure are still working hard to compile and reconcile cash and reserves, review and design new internal control procedures, and validate retiree benefits. I am hopeful that this significant investment in outside experts by PERF will fix many of the major problems that have existed for a very long time and prevent them from happening again. Second, it is very disappointing to learn that the correct actuarial reserve factors adopted by the Board of Trustees on November 19, 2004 to fix a problem identified in earlier audits were not implemented by the June 30, 2005 end of this audit period. I can only assume that they have been implemented by now or that there is a good explanation in the members' interest for why they have not been implemented. Finally, I am pleased to learn that PERF has implemented a new process starting in SFY 2006 to ensure the accuracy of all refund and benefit payments. This mission critical function must never be taken for granted.

I believe it is important to put the problems identified in this audit in a broader context. In the last year, we have witnessed many Wall Street scandals and dramatic challenges to workers and retirees participating in defined benefit plans in the private and public sectors. PERF's commitment to transparency and continuous improvement as demonstrated by many of the comments in this audit is very gratifying. As a result of this important commitment, I am very confident that PERF is a more secure, efficient, and effective financial services organization today than it was on February 10, 2003.

The transformation of PERF into a world class \$12 billion financial services institution for its members, their families and more than 1100 participating employers is well underway thanks to the leadership of the Board of Trustees and the hard work of all employees. In light of this ongoing transformation to excellence, including the many challenges identified in this report, I am very proud to be a PERF member.

Sincerely,

A handwritten signature in black ink, reading "Craig E. Hartzer". The signature is fluid and cursive, with a long horizontal stroke at the end.

Craig E. Hartzer
11374 Bayhill Way
Indianapolis, IN 46236